7 March 2019

EXPLANATION OF THE COUNTERCYCLICAL BUFFER RATE FOR THE REPUBLIC OF SERBIA

Based on Article 14, paragraph 1, item 11 of the Law on the National Bank of Serbia (RS Official Gazette, Nos 72/2003, 55/2004, 85/2005 – other law, 44/2010, 76/2012, 106/2012, 14/2015 and 40/2015 – CC decision and 44/2018) and Section 436 of the Decision on Capital Adequacy of Banks (RS Official Gazette, No 103/2016 and 103/2018, hereinafter: the Decision on Capital Adequacy), at its meeting of 7 March 2019, the NBS Executive Board decided to keep the countercyclical capital buffer rate for the Republic of Serbia at 0%.

The Countercyclical Capital Buffer (hereinafter: CCyB) is additional Common Equity Tier 1 capital that banks are obligated to maintain above the prescribed regulatory minimum in the amount equal to their risk-weighted assets multiplied by the specific countercyclical buffer rate. This instrument mitigates the cyclical dimension of systemic risk, given that it creates an additional buffer of Common Equity Tier 1 capital during periods of excessive credit growth, which can be released when systemic risks materialise.

The National Bank of Serbia sets the CCyB rate for the Republic of Serbia on a quarterly basis, taking into account the reference guide, applicable guidelines and recommendations of the European Systemic Risk Board and other variables it considers relevant for monitoring the cyclical dimension of systemic risk. In accordance with Section 436, paragraphs 2 and 3 of the Decision on Capital Adequacy, the guide for setting the CCyB rate is the deviation of the share of loans in GDP from its long-term trend (credit-to-GDP gap). The CCyB rate for the Republic of Serbia is set in line with the recommendation for setting the CCyB rate of the European Systemic Risk Board (ESRB/2014/1).

Chart 1 shows the share of credit activity to the non-government sector in GDP, the long-term trend and the estimated credit-to-GDP gap.[1] Following a period of expanding credit activity between 2000 and 2008, the credit-to-GDP gap became negative in late 2009. December 2018 data show that the share

[1] Starting from March 2018, the reference guide applied in setting the CCyB rate is the share of loans to the non-government sector in GDP. In the prior period, the reference guide was the share of lending to the non-government sector in GDP, which, in addition to loans, included given deposits, investment, securities and other financial assets, interest, fee and commission receivables and other lending.

of total loans in GDP equalled 72.1%[2], while the estimated credit-to-GDP gap was -9.4 percentage points. The estimated credit-to-GDP gap is recovering but is still below its long-term trend, which indicates that the financial cycle is in a phase in which the introduction of a CCyB rate above 0% could constrain credit activity. The estimated credit-to-GDP gap is below the benchmark value of 2 percentage points,[3] which means that the guide for setting the CCyB rate equals 0%. Nevertheless, closing of the gap in some segments of household lending indicates risk in this part of lending and calls for targeted measures to curb the risk without undesirable repercussions on the overall lending activity. The National Bank of Serbia took a proactive approach to the increasingly recurrent approval of unsecured non-purpose loans to households at unreasonably long maturities, by expanding its supervisory toolkit and adjusting prudential requirements for banks in order to bring the described practice within acceptable bounds. Namely, in December 2018 the National Bank adopted a set of regulations introducing novelties in the field of household lending. Among other things, a new indicator of concentration risk was introduced, which at the level of each bank involves primarily the existing portfolio of cash, consumer and other loans (other than housing loans or current account overdrafts) with the agreed maturity of eight or more years that were approved or will be approved before the application of the new set of regulations. In addition, the National Bank prescribed a 60% debt-to-income ratio – if this ratio is exceeded due to the approval of any loan to a natural person after the entry into force of the new provisions, a bank will be required to separately disclose the receivables from that borrower when reporting to the National Bank of Serbia on the quality of its assets. Also, it was established that if a bank, starting from 1 January 2019, approves a consumer, cash or other loan (other than a housing loan or a current account overdraft) due to which the level of credit debt (debt-to-income ratio) exceeds 60%, or the level of credit debt of the borrower in question exceeded 60% prior to loan approval, the bank will be required to reduce its capital by the total outstanding principal amount of exposure to that borrower until the loan is fully repaid. It was prescribed that if a bank, in the course of 2019, approves a consumer loan (except for consumer loans for the purchase of motor vehicles), cash or other loan (other than a housing loan or a current account overdraft), with the repayment term of eight or more years, it will be required to reduce its capital by the total outstanding principal amount of exposure to that borrower until the

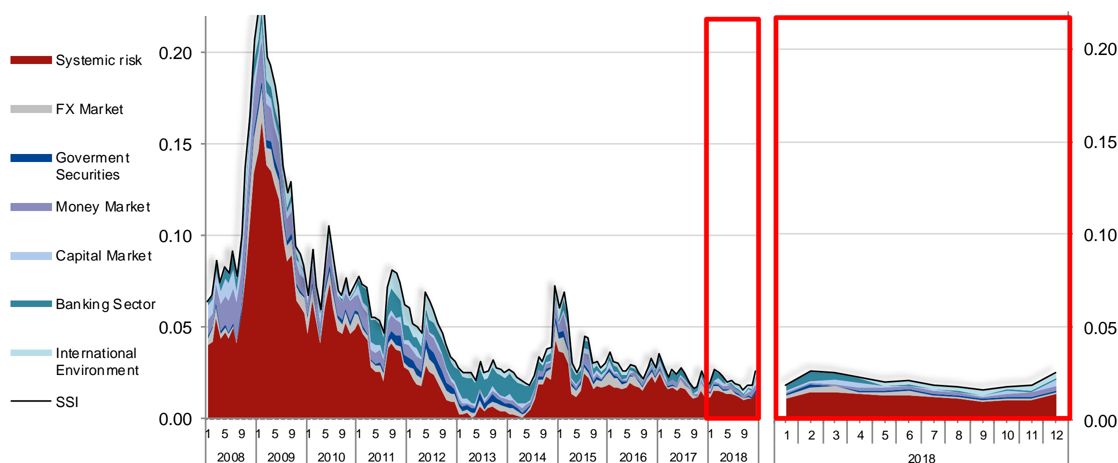
[2] The Serbian Statistical Office revised the GDP data for 2015 and 2016 and the first published estimates for 2017 (as the sum of four quarters). The data series back to 2005 were revised by the end of 2018, and the data before 2005 (starting from 1995) are yet to be revised, i.e. the revision of the whole series will be completed during 2019 - as in the EU Member States.

[3] See: *Recommendation of the European Systemic Risk Board of 18 June 2014 on guidance for setting countercyclical buffer rates (ESRB/2014/1), Annex Part II.*

loan is fully repaid. In 2020 banks will be required to reduce their capital in the same manner when approving the above types of loans with the repayment term of seven years or longer, while starting from 1 January 2021 the same solution shall apply when approving those types of loans with the agreed maturity (repayment term) of six years or longer. It was established that if a bank, starting from 1 January 2019, approves a consumer loan for the purchase of a motor vehicle with the agreed repayment term of eight years or longer, it will be required to reduce its capital by the total outstanding principal amount of exposure to that borrower until the loan is fully repaid.

To set the countercyclical buffer rate for the Republic of Serbia, in addition to the credit-to-GDP gap, additional optional indicators were also taken into account in accordance with Section 436, paragraph 4 of the Decision on Capital Adequacy. Optional indicators for monitoring lending activity were used, which illustrate the characteristics of the domestic financial system, and relate to the real estate market, external imbalance and banking sector developments.

Chart 8 **Systemic stress indicator dynamics and contribution of the most importanr risk factors to the Systemic stress indicator**



Source: National Bank of Serbia.

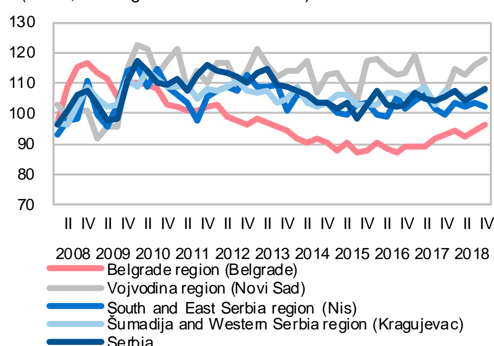
Real estate market

Real estate market indicators for the Republic of Serbia show that this segment of the financial market is recovering.

Serbia's average real estate price, as measured by DOMex, increased by 2.3% y-o-y at end-Q4 2018, and by 1.6% q-o-q.

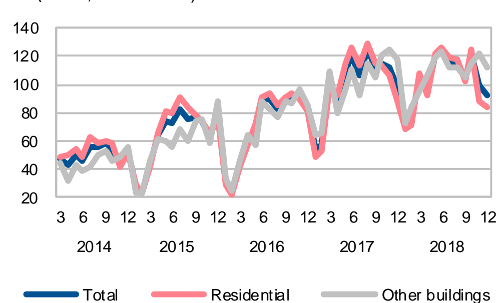
The number of real estate transactions, financed from housing loans insured with the National Mortgage Insurance Corporation, fell slightly in Q4 by 0.8% q-o-q, while rising by 10.6% y-o-y. New housing loans recorded an increase of 4.7% q-o-q. The demand for housing loans is expected to rise in the coming period on the back of the increase in private sector wages and employment as well as favourable terms for housing loans.

Chart 2 **Real estate index DOMex**
(index, average 2002 - 2010 = 100)



Source: National Mortgage Insurance Corporation.

Chart 3 **Indices of the number of newly issued building permits**
(index, 2017 = 100)



Total Residential Other buildings

Source: Statistical Office of the Republic of Serbia.

The recovery of the construction sector is indicated by the number of issued construction permits, which gained around 3.5% at end-2018 from the end of the year before.

The average LTV ratio of new housing loans remains significantly below the regulatory maximum of 80%,[4] amounting to 71.01% in Q4 2018.[5]

Indicators of external imbalance

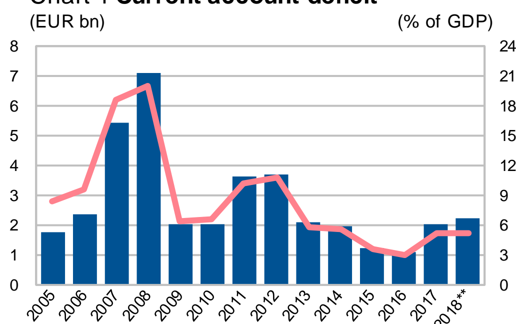
Improvement in domestic macroeconomic conditions reduces sensitivity to external risks. At end-2018, the current account deficit measured EUR 2.2 bn. According to preliminary data, net FDI inflow equalled EUR 1,184.2 mn in Q4, fully covering the current account deficit. Net FDI inflow in 2018 was higher than expected, reaching EUR 3.2 bn, which is more than enough to fully cover the current account deficit. In the medium term, it is expected that the current

[4] In accordance with the Decision on Measures for Safeguarding and Strengthening Stability of the Financial System (RS Official Gazette, Nos 34/2011 and 114/2017), banks may approve mortgage loans provided that the amount of the loan does not exceed 80% of the value of the property mortgaged, unless a loan is approved in the context of government support measures for some categories of natural persons, in which case the loan may not exceed 90% of the value of the property.

[5] According to data of the National Mortgage Insurance Corporation for new loans insured with the Corporation.

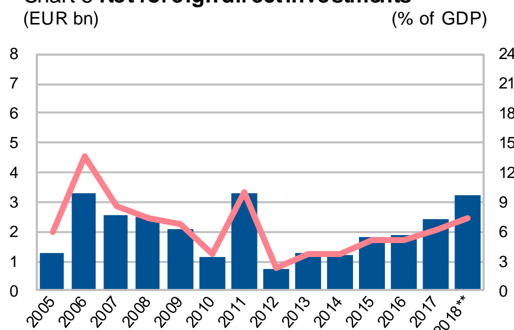
account deficit will measure around 4-5% of GDP and that FDI inflow will remain more than sufficient for its full coverage.

Chart 4 **Current account deficit**
(EUR bn) (% of GDP)



*Starting from 2007 data on exports and imports of goods and services are shown in accordance with BPM6. Data for 2005 and 2006 are shown according to BPM6.
** NBS estimate Q4 2018.
Source: Statistical Office of the Republic of Serbia and NBS.

Chart 5 **Net foreign direct investments***
(EUR bn) (% of GDP)

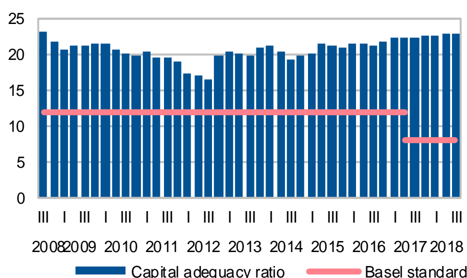


*Starting from 2007 data on exports and imports of goods and services are shown in accordance with BPM6. Data for 2005 and 2006 are shown according to BPM6.
** NBS estimate, Q4 2018.
Source: Statistical Office of the Republic of Serbia and NBS.

Main banking sector indicators

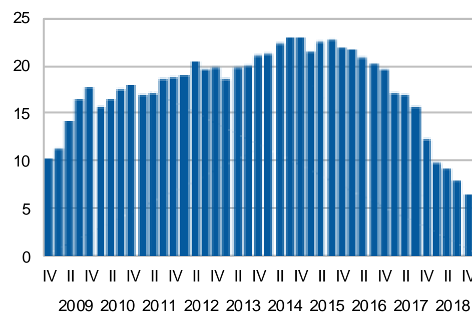
The banking sector is adequately capitalised and highly liquid. A declining level of NPLs, the fact that there is no concentration of some types of assets in the banking sector, and the satisfactory degree of competition testify to the stability of the banking sector.

Chart 6 **Capital adequacy ratio**
(%)



Source: National Bank of Serbia.

Chart 7 **Non-performing loans**
(share in total gross loans, %)



Source: National Bank of Serbia.

At end-Q3 2018, the capital adequacy ratio was 22.8%[6], well above the regulatory minimum (which as of 30 June 2017 equals 8%).

The LTD ratio (ratio of loans to deposits) stayed below 1, at 0.84 at end-Q4 2018 indicating that banks rely more on domestic, stable sources of funding.

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[6] The latest available data.

The share of NPLs in total loans of the banking sector continued to trend down in 2018, to 5.7% at end-2018, which is below the pre-crisis level and the lowest level on record for this indicator of bank asset quality. The reduction in the share of NPLs largely resulted from the activities implemented in accordance with the NPL Resolution Strategy and action plans of the Government and the NBS.

Assessment of systemic risk of the Serbian financial system

The systemic stress indicator (hereinafter: SSI) was developed with a view to identifying periods of elevated stress and the level of systemic risk in the financial system of the Republic of Serbia. The SSI covers a series of indicators which capture the level of financial stress in six key segments of the Serbian financial system: the FX market, government securities market, money market, capital market, banking sector and the international environment.

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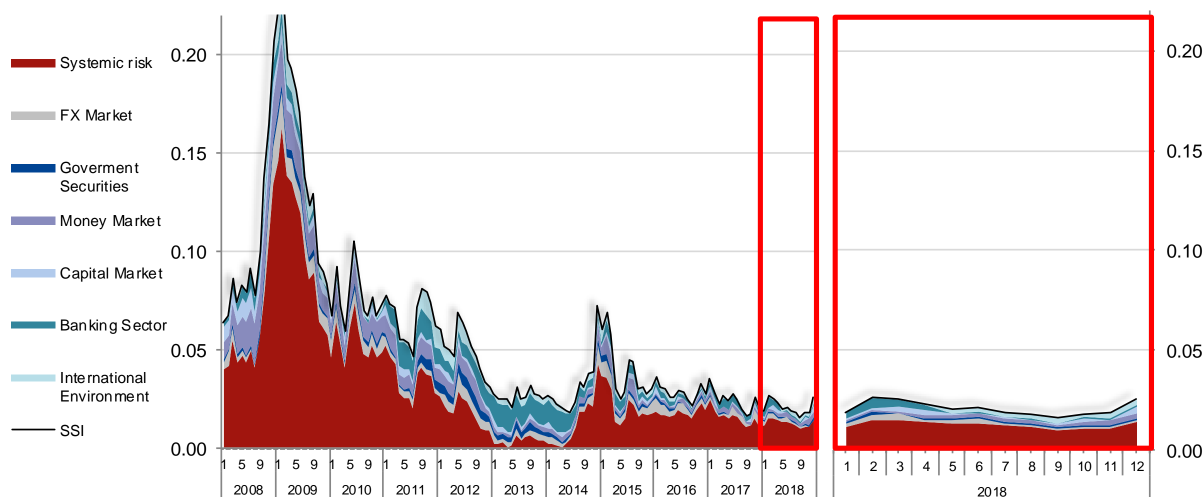

Source: National Bank of Serbia.

From end-2017 to end-2018, the SSI suggested a period of low risk, with a low and stable systemic component.

Developments in the foreign exchange market did not significantly affect the SSI level in Q4 2018. Furthermore, the achieved results and the domestic macroeconomic indicators point to a low level of financial stress originating from the public finance. The average EMBI for Serbia was up by 19 bp in Q4 2018 relative to the same period of the year before due to rising protectionism in international trade, which also fuelled greater volatility in global financial markets. Notwithstanding the increase in Q4, at end-2018 Serbia's risk premium was one of the lowest in the region.

The NBS monetary policy easing, an adequate level of required reserves and low interest rates in the euro money market marked 2018 and affected favourably the domestic money market which therefore cannot be regarded as a source of the risk of systemic stress in the Serbian financial system. Trends in the capital market did not significantly affect the level of systemic stress in the financial system of the Republic of Serbia in Q4 2018, except in December when the turnover was higher.

Continuous improvement of the National Bank's regulatory measures has led to an improvement in relevant banking sector indicators in 2018 as well, which increased further the resilience of the financial system to potential shocks. Quarterly macroprudential stress tests of the banking sector carried out by the National Bank of Serbia confirm adequate capitalisation and high liquidity of the Serbian banking sector.

Also, in December 2018, Standard & Poor's upgraded its outlook on Serbia to positive from stable, and affirmed its 'BB' long-term foreign and local currency sovereign credit rating. As stated by Standard & Poor's, the outlook revision reflects Serbia's strong economic growth and the results of monetary policy in terms of preservation of price and financial stability.

Low inflationary pressures, successful fiscal consolidation and continued structural reforms, higher FDI inflow, cautious monetary policy easing, together with a stable banking system, boost the resilience of the domestic financial system and thus macroeconomic stability of the country.